In the Supreme Court of the United States

OCTOBER TERM, 1965

No. 103

UNITED DRAPERIES, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

During the taxable years in issue (April 1, 1956 to December 31, 1960) petitioner was engaged in the production and sale of draperies to manufacturers of mobile homes. Among petitioner's customers were Mid-States Corporation and its subsidiaries. Pursuant to a side agreement, petitioner paid three officers of Mid-States or its subsidiaries specified percentages (ranging up to 13%) of sales by petitioner to Mid-States and its subsidiaries. The Commissioner disallowed $138,423.61 of such payments deducted by

petitioner. In addition, the Commissioner disallowed $21,432.55 constituting gifts of cash, suits, furniture and automobiles by petitioner to the three officers (Pet. App. 1-3).

The Tax Court held that these payments were not deductible expenses within § 162 of the Internal Revenue Code of 1954 for three separate reasons. First, the Tax Court found that the payments frustrated sharply defined national or State policy (R. 33-35).[1] It cited the Federal Trade Commission regulation prohibiting a supplier from "Secretly giving . . . employees of customers . . ., without knowledge or consent of their employers, as inducement to purchase products . . ., money or anything of value . . ." (16 C.F.R. 3.310 (1949 ed.)). Since some of the payments were mailed into Michigan, the court also cited a Michigan criminal statute prohibiting any person from giving ". . . an agent . . . of another . . . any commission, gift or gratuity . . . with intent to influence the action of such agent . . . in relation to his principal's . . . business . . ." (Michigan Stat. Ann., § 28.320).

Second, the Tax Court held that the payments were not "ordinary" since there was no evidence that such payments were commonly made in petitioner's industry (R. 32). In fact, petitioner's president testified that it made no such payments to the employees of any of its other customers (R. 32).

Third, the Tax Court found that the payments were not "necessary," since there was no evidence that peti-

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[1] "R" references are to the petitioner's printed appendix in the court of appeals.

tioner would not have gotten the business without the payments (R. 32-33).

The court of appeals affirmed on the ground that the "kickbacks" were not ordinary because "there is nothing to show that the practice was a normal incident to the drapery manufacturing industry or to suppliers of mobile home manufacturers generally." (Pet. App. 4-5)[2] The court of appeals did not discuss the other two grounds relied upon by the Tax Court (Pet. App. 1-5).[3]

In *Tank Truck Rentals* v. *Commissioner*, 356 U.S. 30, 33-34, this Court held that expenditures which "frustrate sharply defined national or state policies proscribing particular types of conduct, evidenced by some governmental declaration thereof" are not deductible. The Court stated that "the test of nondeductibility always is the severity and immediacy of the frustration resulting from allowance of the deduction" (*id.* at 35). And the Court concluded: "Certainly the frustration of state policy is most complete and direct when the expenditure for which deduction is sought is itself prohibited by statute" (*ibid*). In the instant case petitioner's payment of

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[2] Both lower courts also correctly determined that the kickbacks were not excludable from petitioner's gross income as rebates to customers (Pet. App. 5, R. 35). Petitioner has not raised this issue in his petition.

[3] There is no basis in fact for petitioner's assertion that the government abandoned its reliance on the public policy doctrine in the court of appeals (Pet. 6, 14 n. 4). Government counsel orally stated to the court of appeals that it could decide this case on the ground that the kickbacks were not "ordinary" expenses without reaching the public policy issue.

the kickbacks constituted a violation of long-standing FTC regulations and, as to those kickbacks mailed into Michigan, a violation of that State's criminal statutes. The very payments here disallowed are thus themselves a violation of "sharply defined . . . policies . . . evidenced by [a clear] . . . governmental declaration". To permit a deduction for such kickbacks would "frustrate" public policy even more than granting a deduction for fines and penalties levied as punishment for violating the law. See *Tank Truck Rentals* v. *Commissioner*, *supra*.[4]

Moreover, this Court, in *Deputy* v. *DuPont*, 308 U.S. 488, 495, stated that while "an expense may be ordinary though it happen but once in the taxpayer's lifetime . . . [y]et the transaction which gives rise to it must be of common or frequent occurrence in the type of business involved." And in *Lilly* v. *Comissioner*, 343 U.S. 90, the Court required proof of a "long-established practice in the optical industry in the localities where petitioners did business" before it would permit a deduction for kickbacks from optical companies to prescribing doctors (at 93). Here the evidence showed that the payment of kickbacks was not a practice in either the industry or the localities

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[4] Because the expenditures here are themselves prohibited and thus their deductibility would constitute the severest and most immediate type of frustration of sharply defined public policy, we believe that the Seventh Circuit's decision should be permitted to stand regardless of this Court's action in *Commissioner* v. *Tellier*, No. 351, Oct. Term, 1965, pending on petition for certiorari, involving the deductibility of legal expenses incurred in the unsuccessful defense of a business-related criminal prosecution.

where petitioner did business and that the transactions giving rise to petitioner's claimed deductions were not of common or frequent occurrence in the type of business involved. The kickbacks were thus not "ordinary" within the meaning of Code Section 162.

The cases cited by petitioner involve factual situations widely variant from the instant case, and thus they are not in conflict with the present decision.

For these reasons the petition for a writ of certiorari should be denied.

Respectfully submitted,

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JULY, 1965

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